Introduction of the recent case in international taxation about to what extent the substance over form principle is applicable

As taxation is a very important factor that has a considerable influence on the rate of return of a cross-border investment, a tax treaty between countries is another very important factor to take into account. In general, a tax treaty between countries is concluded modeled upon the OECD Model Tax Convention or the UN Model Tax Convention with any revisions made as deemed necessary by the countries. The OECD Model Tax Convention provides that the income-source country shall impose taxes on the real-estate income of the 'resident' of a contracting state but the resident country shall impose taxes on gains from share transfers. In contrast, the UN Model Tax Convention provides that the income-source country shall have the taxation right with respect to gain from a share transfer if the share acquisition exceeds certain threshold and the resident country shall have such taxation right in other cases, although the UN Model Tax Convention shares some similarity with the OECD Model Tax Convention in that the income-source country shall impose taxes on the real-estate income of the resident of a contracting state under the UN Model Tax Convention and the OECD Model Tax Convention. The terms and conditions of a tax treaty are determined by negotiations and consultations between both parties referring to such model tax conventions. Because tax treaties differ on the treatment of gains from share transfers, there are differences in many cases of actual taxation depending on which tax treaty is applied.

It is a very important issue for an investor making investment in shares in a foreign company which tax treaty is applicable to such investment. For example, while only the tax treaty between Country A and Country B is an important issue in case an investor of Country A invests in a company of Country B, if such investor of Country A makes investment in such company of Country B via Country C, not only the tax treaty between Country A and Country B but also those between Country A and Country C and between Country B and Country C need to be considered. In the event the investor of Country A makes investment via more countries, more tax treaties need to be considered.

In the event a foreign corporation establishes a SPC in a tax haven and makes an investment in Korea, and then makes income from such investment, such SPC meets the requirements for the 'resident' in the tax haven in most cases as it is established under license or authorization pursuant to the provisions of local laws. Therefore, generally, an investor who established a SPC in a contracting state in order to invest in shares in the other contracting state under tax planning argues that (i) such SPC shall not be subject to taxation by the other contracting state as it constitutes a 'resident' of a contracting state, and (ii) the status of the 'resident' of the SPC recognized by a contracting state under the tax treaty shall not be denied and the benefits under such tax treaty shall not be deprived under the substance over form principle pursuant to the internal law of the other contracting state, and (iii) even if the substance over form principle is applicable, the tax treaty between a contracting state and the other contracting state shall apply to the SPC as it is a company with legal substance, not a conduit.

The Korean taxation authorities treat a SPC of an investor as a conduit of the investor and applies the substance over form principle to the SPC under the domestic tax laws, and accordingly impose corporate income taxes on the investor treating the investor as the owner of the capital gain from the share-transfer transaction if the SPC was created as a formality according to the pre-designed investment/governance structures only for tax-avoidance purposes through 'Treaty Shopping' regardless of whether the SPC is a resident of a contracting state.

Courts in Korea have accepted such position of the Korean taxation authorities. In fact, regarding several recent cases in which it was a point of issue whether the tax treaty is applicable or not, the court has consistently denied the application of the benefits under the tax treaty between a contracting state and the other contracting country, applying the substance over form principle in line with the position of the Korean taxation authorities as above, and ruled that the applicable tax treaty is the one signed by and between a country of which the actual investor is a resident and the other contracting state.

Such judgments above are based on a view that the substance over form principle may be applied as a standard of the interpretation of the relevant tax treaty even if such tax treaty does not contain separate provisions on the substance over form principle as the principle is based on the Constitution. The position of Korean courts is that as the substance over form principle is a legal system designed to realize the principle of equality of tax burden, which has been derived from the principle of equality or that of prohibition of discrimination as provided in Article 11.1 of the Constitution of the Republic of Korea.

Then, arguments can be made about to what extent the substance over form principle is applicable. It is clarified by existing precedents that (1) the substance over form principle shall apply in determining who is a 'party to which the capital gain belongs to' at least, and (2) the application of the substance over form principle shall neither deny the effect of an agreement under private laws validly constituted between the parties nor create a new agreement.

Regarding the point at issue as above, an interesting judgment has recently been made about the extent of the application of the substance over form principle to an international transaction, although it was a court of first instance case. (Seoul Administrative Court Case No. 2010 Guhap 3550)

Company A located in Country X held 100% of the shares in Company B1 and Company C1, and Company B1 and Company C1 held 100% of the shares in Company B2 and Company C2 respectively, both of which are residents of the Netherlands. Company B2 transferred 20% shares in a Korean Company H to Company C2 in 2006 in order to rearrange the overall shareholding structure among its subsidiaries. Company C2, which was obliged to collect a withholding tax on the gain from the share-transfer transaction above, did not pay the corporate income tax on the transaction by making an application for the exemption of the corporate income tax for Company B2 to the taxation authorities pursuant to the Korea-Netherlands Tax Treaty.

However, under the substance over form principle, the Korean taxation authorities imposed the corporate income tax on Company C2 under the tax treaty between Korean and Country X on the grounds that (i) Company B2 is merely a conduit company with no legal substance established as a formality to ensure that Company A is covered by the Korea-Netherlands Tax Treaty, and (ii) Company A located in Country X at the top of the hierarchy of the relevant companies is an actual party to the share-transfer transaction and a substantial owner of the capital gain therefrom.

As Company C2 objected to such corporate income tax disposition, the court judged that the disposition shall be unlawful on the grounds that "it cannot be concluded that the capital gain was generated for Company A since Company C2, the transferee, is Company A's conduit company as there is no difference in substance between Company C2 and Company B2, the transferor" though it deemed that Company A shall be the substantial owner of the capital gain considering Company B2 as a conduit company of Company A as the taxation authorities did.

Though this judgment was made by a court of first instance, it is a meaningful decision in that it clarified that the substance over form principle applies to find not only the party to bear the tax burden but also the substantive reality of the transaction, and its reasoning that a transaction between two conduits under the same parent does not create a taxable gain.

This precedent will probably be a noteworthy judgment on the inter-affiliate shareholding structure changes in an international investment context.

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